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No. 00-1422

IN THE

Supreme Court of the United States

THE KROGER CO.,
Petitioner,

v.

THE KANSAS DEPARTMENT OF REVENUE,
Respondent.

On Petition for Writ of Certiorari to the Supreme Court of Kansas

BRIEF OF *AMICUS CURIAE* COMMITTEE ON STATE TAXATION IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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INTEREST OF THE *AMICUS CURIAE*

The Committee On State Taxation (COST) submits this brief as *amicus curiae* in support of Petitioner in the above captioned matter.[1] COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. COST is a non-profit trade association that was organized in 1969 as an advisory committee to the Council of State Chambers of Commerce. COST, which was separately incorporated on January 1, 1992, has a membership of over 550 multistate corporations involved in interstate and international commerce.

COST submits this brief to highlight a new and expanding approach states are using to unconstitutionally expand their tax base. On the heels of this Court's decision in *Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458 (2000), Kansas seeks to impose "a deduction limitation [that] would seem, in fact, to amount to an impermissible tax." *Id.* at 465. Kansas has reached beyond its borders to unconstitutionally extract taxes from an interstate business by requiring the business to allocate its interest expense to another state. *Amicus* hopes that the Court will not allow this type of unconstitutional expense disallowance to occur after *Hunt-Wesson*. Failing to grant Certiorari would encourage taxing authorities to use this new method of expense disallowance as a means of expanding their tax base. Such a diminution in taxpayers' constitutional protection threatens the foundations of the state tax system by risking excessive burdens on commerce. COST and its members are concerned that such burdens could become institutionalized elements of state tax

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[1] No counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary contribution to the preparation or submission of this brief. Written consent of the Petitioner and Respondent has been obtained and filed with the Clerk of the Court.

systems. Further, Kansas' statutory provision governing apportionability is shared by many states. Thus, the Court's action on the Petition for Writ of Certiorari in this case will instruct states whether such provisions may be used to expand the tax base as Kansas has done. COST and its members have a particular interest in seeing the Kansas approach to expense disallowance reviewed (and invalidated) both because of the direct impact on the efforts of the tax department in Kansas and the resulting impact on states attempting this approach across the country. COST and its members request this Court to reiterate and expound upon the constitutional principles prohibiting the tax on extraterritorial values suffered by Petitioner and many similar taxpayers in Kansas and elsewhere.

SUMMARY OF THE ARGUMENT

COST asks this Court to accept the case and determine that Kansas violated the Due Process and Commerce Clauses of the United States Constitution by taxing income with no relation to the state. Taxation of extraterritorial value occurs here, as in *Hunt-Wesson*, as a result of the State's denial of the Petitioner's interest deduction in violation of the unitary business principle. Reducing a tax benefit (*i.e.*, a deduction) generates the same result as taxing the nonunitary income directly. States cannot end-run the unitary business limitation by disguising a tax on extraterritorial income as an expense disallowance.

The unconstitutional treatment of Kroger's interest expense stems from the State using its rule for apportioning income to determine whether an expense should be apportioned or allocated. This Court established the unitary business principle as the backstop for determining the scope of a state's constitutional ability to reach income. The principle defines the outermost parameters of a state's ability to subject income to tax. Within that limitation, many states have

legislatively adopted the Uniform Division of Income for Tax Purposes Act (UDITPA). Compared to the parameters established by the unitary business principle, UDITPA statutorily captures a narrower spectrum of income for apportionment. Several state tax authorities have drawn the conclusion that UDITPA's definition of income subject to apportionment, "business income," relies on two tests, the transactional and functional tests, which, when combined, result in a defined tax base falling, necessarily, within the constitutional definition of "unitary" income. The courts of the State of Kansas have interpreted UDITPA, and narrowed the scope of income subject to apportionment by adopting only the transactional test of UDITPA. Although these narrower tests suffice for determining *income* subject to apportionment, and states are within their prerogative in doing so, application of a narrower test to determine *expense disallowance* creates an unconstitutional violation of the unitary business principle by calculating "business income" in an amount that exceeds Kroger's total unitary income. It is the narrow transactional test that Kansas applied to determine that Kroger's interest expense should be allocated instead of apportioned.

Because the disallowance of expenses results in the indirect taxation of income, any test, whether applied to an item of income or expense, which results in apportionable income in excess of "unitary" income, is not permissible. In this case, when the narrow transactional test is applied to expense determination, it disallows expenses that meet the Constitution's broader unitary business principle. As a result, expenses which were clearly related to the unitary business (but didn't satisfy the Kansas transactional test) were disallowed, thereby subjecting the taxpayer to tax on extraterritorial value in the same manner that California's unconstitutional interest disallowance was held to impermissibly result in taxation of nonunitary income.

ARGUMENT

I. Under the Due Process and Commerce Clauses of the United States Constitution, the Unitary Business Principle Operates to Limit the Income that Kansas May Include in its Apportionable Tax Base.

Although this case involves a state's effort to disallow an apportioned expense, Kansas used the rules for apportioning and allocating income to reach its determination. Whether used to apportion income or deny an apportioned expense, these rules impact the amount of income subject to tax by the State and must therefore be analyzed under the constitutional standards applicable to taxation of multistate businesses. Both the Commerce and the Due Process Clauses limit a state's ability to tax a nondomiciliary corporation's multistate income. U.S. Const. art. I, § 8, cl. 3; U.S. Const. amend. XIV, § 1. Consistent with these constitutional limitations, a state's ability to tax income earned by a multistate business requires a "minimal connection" between the interstate activities of the corporation and the taxing state. *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 436-437 (1980) (quoting *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 272-273 (1978)); *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-345 (1954). States are prohibited from taxing a nondomiciliary corporation's income, if that income is "derive[d] from 'unrelated business activity' which constitutes a 'discrete business enterprise.' " *Exxon Corp. v. Department of Revenue of Wis.*, 447 U.S. 207, 224 (1980)(quoting *Mobil Oil*, 445 U.S. at 442).

These principles form the umbrella that is the unitary business principle applicable to income. Only income falling under this umbrella may be taxed on an apportioned basis by a nondomiciliary state. A variety of relationships between the income and the state will place the income under the umbrella. For example, the income may have been directly

earned by activities within the state—a sales person selling the taxpayer's product in the state; the income may also be taxed if it is attributable to activities both within and outside the state and is part of the taxpayer's "unitary business." *Mobil Oil*, 445 U.S. at 438. States are prohibited, however, from taxing income that bears no rational relationship to the in-state value of the corporate enterprise. *Allied-Signal, Inc. v. Director, Div. of Tax'n*, 504 U.S. 768, 772, (1992).

In determining whether the appropriate relationship exists, this Court has said that the "linchpin of apportionability in the field of state income taxation is the unitary business principle." *Mobil Oil*, 445 U.S. at 439. The Court in *Mobil Oil* looked to three factors to determine the existence of a unitary business: 1) functional integration; 2) centralization of management; and 3) economies of scale. *Id.* at 438. The Court held that Mobil failed to prove that the state was taxing extraterritorial value. A taxpayer must show that its income was earned in a discrete enterprise, unrelated to the activities pursued in that state, to prove that income is not subject to apportionment. *Id.* at 439.

The Court further refined the unitary business principle in *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983). In *Container Corp.*, the Court's analysis relied on *Mobile Oil* and distinguished between a capital transaction that serves an investment function and one that serves an operational function. *Id.* at 180, n.19. The Court noted that a unitary business might be shown without a flow of goods between entities, as long as there is a flow of value.

Most recently, in *Allied-Signal, Inc. v. Director, Div. of Tax'n*, 504 U.S. 768 (1992), the Court struck down New Jersey's efforts to include nonunitary income in the tax base. In its decision the Court reaffirmed the unitary business principle as the appropriate standard for limiting a state's power to tax value outside its borders. The Court also rejected the Multistate Tax Commission's (MTC) request that

the Court adopt the Uniform Division for Tax Purposes Act (UDITPA) definition of "business income" as the standard for the unitary business principle. *Id.* at 786; UDITPA § 1(a). Instead, the Court articulated the test for determining apportionable income, which it phrased in terms of the relationship between the income and the operations of the taxpayer in the taxing state; income resulting from investment is insufficient. *Allied-Signal,* 504 U.S. at 787. Under this test, a transaction or activity generates apportionable income if "the capital transaction serve[s] an operational rather than an investment function." *Id.* at 787.

As summarized above, this Court's prior decisions have created a broad range of tests to determine whether income is unitary and thus apportionable. These tests, when taken together, establish the outermost edge of the unitary business umbrella. Although states may tax a share of income falling under the umbrella, a state that tries to tax income outside the umbrella is constitutionally all wet.

II. The Uniform Division of Income for Tax Purposes Act (UDITPA) Statutorily Narrows the Income that States May Include in their Apportionable Tax Base and Kansas' Interpretation of UDITPA Further Narrows the Tax Base by Adopting Only the Transactional Test.

In understanding the rules for apportionment, one must look not only at the unitary umbrella but also at the statutory rules states use to define the scope of income they seek to tax. In that regard, the Uniform Division of Income for Tax Purposes Act (UDITPA) establishes general definitions of income used to accomplish distribution of income through allocation and apportionment among the states. Rather than rely on the unitary business principle, UDITPA separates income into items that are apportionable, which it calls business income, and items that are allocable, which it calls nonbusiness income. These definitions, when compared with

the scope of the unitary income umbrella, are somewhat narrower than the income states are constitutionally permitted to tax. UDITPA was drafted in an effort to develop a uniform method of making apportionment and allocation decisions. In 1956, the first draft of UDITPA was presented to the National Conference of Commissioners on Uniform State Laws (NCCUSL).[2] The original draft did not distinguish between business and nonbusiness income but simply assigned certain intangible income and capital gains to the corporation's commercial domicile. The draft was revised in 1957 using the current business/nonbusiness income test to determine whether income should be allocated or apportioned.[3] Kansas adopted its original version of UDITPA in 1963.[4]

UDITPA § 1(a) defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." *Id.* Nonbusiness income is defined as "all income other than business income." UDITPA § 1(e).

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[2] The history of the UDITPA is taken from William J. Pierce, *The Uniform Division of Income for State Purposes*, Taxes-the Tax Magazine Vol. 35 No. 10 (October 1957), and James H. Peters, *The Distinction Between Business Income and Nonbusiness Income*, 1973 So. Cal. Tax Inst. 251.

[3] *Id.;* Unif. Div. of Income for Tax Purposes Act § 1, 7A U.L.A. 336 (West 1985 & Supp. 1995).

[4] Kan. Stat. Ann. §§ 79-3271 to 79-3293. Twenty-one other states plus the District of Columbia have adopted some form of UDITPA language including: Alabama, Alaska, Arizona, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kentucky, Maine, Michigan, Missouri, Montana, Nebraska, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington.

In several states, the UDITPA business income definition has been interpreted as incorporating two alternative tests for determining whether income is business income: the transactional test and the functional test.[5] The transactional test requires that income be considered business income if it arises from transactions and activities in the regular course of the taxpayer's trade or business. UDITPA § 1(a). For example, a sale of a factory by the business would be considered unusual and extraordinary, and thus, would fail the transactional test as being outside the regular course of business. Under the functional test, however, if the acquisition, management, and disposition of the asset generating the income constitutes an integral part of the taxpayer's regular trade or business operations, the income will be considered apportionable business income. The functional test focuses on the relationship between assets giving rise to taxable income and the business itself. Under the functional test, the gain or loss from the sale would be considered business income if the factory was acquired and used in the taxpayer's trade or business. If either test is satisfied, the income is business income. In states that use the transactional test as the sole test for classifying income, like Kansas, the gain on the sale of the factory would not be business income because the sale was not in the regular course of the taxpayer's business. Transactional-test states, therefore, have a much narrower approach to determining apportionable income than do states with both tests or states that rely entirely on the unitary business concept to determine apportionable income.[6]

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[5] *See* 1 John C. Healy, *2001 Multistate Corporate Tax Guide: Corporate Income Tax*, at I-660 (2001).

[6] We do not contend that the statutory UDITPA language includes one or two tests, a matter left for state courts to reach in interpreting their state statutes.

In *Allied-Signal*, this Court was encouraged to adopt the business/nonbusiness income tests of UDITPA as the constitutional test for the unitary business principle. *Allied-Signal*, 504 U.S. at 786. Refusing to equate the flexible unitary business principle with the inflexible statutory language of UDITPA, the Court was only willing to go as far as stating "[i]n the abstract, these definitions may be quite compatible with the unitary business principle." *Id.* at 786. In fact, they are compatible in that the business income concept of UDITPA fits within the unitary income concept developed by this Court; and, the nonbusiness income concept of UDITPA similarly fits within nonunitary income. The UDITPA standard is but a subset of the unitary concept. By its very nature, the flexibility of the unitary concept encompasses a broader scope of income than the statutory provisions of UDITPA.

Even states that have interpreted their statute to contain both tests do not capture all of the income under the unitary business umbrella. UDITPA does not contain any "requirement that [its] business income definition extend as far as the Constitution permits." 1 Jerome R. Hellerstein & Walter Hellerstein, *State Taxation*, § 9.05[1][b] (3d ed. 1998). The cases litigating whether the business income definition includes one or two tests are not "seriously influenced by federal constitutional restraint." *Id.* Whether states have adopted one or both the transactional or functional tests, the state statute forms an umbrella fitting within the unitary business umbrella.[7]

The narrowness of UDITPA can be clearly seen by comparing the statutory provisions of "full apportionment" states like Massachusetts with the UDITPA states' definition of business income. As an example, Massachusetts requires

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[7] Some state courts have inappropriately interpreted UDITPA in a manner that is broader than allowed by the unitary business principle.

corporate taxpayers to apportion all income if they have business activity taxable both within and without the State. Mass. Gen. Laws ch. 63, § 38(c). The only limit on Massachusetts' full apportionment provision is the unitary business principle. This limit, not even appearing in the State's statute, was clarified in Massachusetts Department of Revenue Technical Release 92-5, (October 9, 1992 TIR 92-5). Accordingly, although the State statute requires that taxpayers apportion every dollar of income, the State's TIR requires taxpayers to exclude income which is nonunitary so as not to violate the unitary business principle. According to TIR 92-5, only income qualifying as nonunitary under the principles enunciated in *Allied-Signal* may be excluded from the apportionable base. Using this approach, Massachusetts seeks to apportion the full amount of income that is constitutionally permissible.

Maryland is another jurisdiction that has adopted statutory provisions much broader than UDITPA. Md. Code Ann. Tax-Gen. § 10-402, requires a unitary business to allocate to the State that part of the corporation's income "derived from or reasonably attributable to trade or business carried on in the State." *Id.* In *Hercules Inc. v. Comptroller of the Treasury*, 716 A.2d 276 (Md. 1998). the Court of Appeals of Maryland held that "[t]he legislative purpose underlying this statute is to tax multi-state corporations doing business in Maryland to the bounds permitted by the United States Constitution." *Id. at 280.* By regulation the State makes clear that apportionment is required of any income generated by a unitary business. Md. Regs. Code tit. 03 § 04.03.08 (2001). Again, the State's statute and regulations go further than UDITPA and reach the full extent of constitutionally permissible taxation.

In 1963, Kansas adopted its version of UDITPA contained in Kan. Stat. Ann. §§ 79-3271 to 79-3293, which is modeled on the Uniform Division of Income for Tax Purposes Act

(UDITPA). Kan. Stat. Ann. § 79-3271(a) defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Kansas defines nonbusiness income as "all income other than business income." Kan. Stat. Ann. § 79-3271(e). The Kansas Supreme Court interpreted the State's version of UDITPA as containing only the transactional test in *Western Natural Gas Co. v. McDonald*, 446 P.2d 781 (Kan. 1968). This decision was affirmed in *In the Matter of the Appeal of Chief Industries, Inc.*, 875 P.2d 278 (Kan. 1994).[8]

The Kansas *Chief Industries* case is a prime example of the narrowing of apportionable income accomplished by the transactional test. Chief Industries was headquartered in Nebraska and owned a recreational vehicle production facility in Kansas. In 1972, Chief Industries established an automotive division, Chief Automotive, to produce and sell automobile frame straighteners. By 1983, Chief Industries was experiencing liquidity problems. To raise capital, Chief

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[8] In addition to Kansas, other states such as Iowa, New Mexico and Tennessee found that their state's version of UDITPA's business income definition contained only a transactional test. *See Phillips Petroleum Co. v. Department of Revenue & Fin.*, 511 N.W.2d 608 (Iowa 1993); *McVean & Barlow Inc. v. New Mexico Bureau of Revenue*, 543 P.2d 489 (N.M. Ct. App. 1975); *General Care Corp. v. Olsen*, 705 S.W.2d 642 (Tenn. 1986); *Federated Stores Realty, Inc. v. Huddleston*, 852 S.W.2d 206 (Tenn. 1992); *Union Carbide Corp. v. Huddleston*, 854 S.W.2d 87 (Tenn. 1993); *Associated Partnership I, Inc. v. Huddleston*, 889 S.W.2d 190 (Tenn. 1994). However, strict use of the transactional test caused a substantial loss of revenue, forcing Kansas, New Mexico and Tennessee to amend their statutes. Now, those states generally accept both the transactional and the functional tests to determine whether income is apportionable business income.

Industries separately incorporated Chief Automotive selling stock at public offering to raise $30 million in funds, which were used for the general business needs of Chief Industries. On audit, the Kansas Department of Revenue challenged Chief Industries' allocation of its stock sale proceeds as nonbusiness income.

The Department argued in *Chief Industries* that the *Allied-Signal* decision mandated the use of an independent functional test when determining whether income falls under the UDITPA definition of "business income." On appeal, the Supreme Court of Kansas rejected the Department's argument and interpreted the Kansas statute to contain only the transactional test, relying on *Western Natural Gas*. Using the transactional test, the Supreme Court of Kansas found that the gain from the sale of stock was nonbusiness income and, therefore, not apportionable to Kansas. The Supreme Court of Kansas could have reached a different result had it applied the functional test. The decision did not criticize the lower court's application of the functional test to Chief Industries' stock sale; instead, the Court focused solely on whether the functional test existed under Kansas' version of UDITPA and *Western Natural Gas*. Had the Kansas UDITPA provision been interpreted to include the functional test, *Chief Industries* might have been decided differently.[9] In fact, the Kansas legislature recognized the narrowness of the State's transactional test and amended the State's version of UDITPA to provide for an elective functional test. Income Tax Unif. Div. of Income for Tax Purposes Act, L. 1996, ch. 264, § 1; July 1.

Kansas' transactional test for determining apportionable income reaches a narrower scope of income than state

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[9] The Board of Tax Appeals found that the gain on the sale of stock qualified as business income under the functional test but not under the transactional test. *Chief Industries*, 875 P.2d at 281.

UDITPA provisions, which have been interpreted to contain both tests. The Kansas' transactional test also reaches a much narrower scope of income than permitted by the constitution's unitary business principle. Although Kansas is entitled to statutorily refrain from taxing the full extent of income permitted by the Constitution, it cannot use the narrow income test to determine whether to allow the deduction of apportioned expenses. By using the transactional test, Kansas' focus on whether the interest expense at issue was in the regular course of the taxpayer's trade or business misses the boat. The appropriate analysis is that used by this Court in *Hunt-Wesson*, whether the expense disallowance results in taxation of extraterritorial value. Using the narrow transactional test, and failing to apply the broader unitary business principle to expenses results in expense disallowance that is tantamount to the imposition of tax on extraterritorial income.

III. Kansas' Application of the UDITPA Transactional Test to Disallow Expenses Results in Tax on Extraterritorial Values.

Kansas' application of the transactional test to Kroger's interest expense resulted in taxation of extraterritorial values. When compared with the two UDITPA tests or the unitary business principle, the transactional test excludes a broader scope of income from apportionment. In its application to expenses, the transactional test also eliminates a broader scope of deductions. Because the disallowance of expenses results in the indirect taxation of income, the transactional test is not an appropriate means to analyze whether expenses should be allocated or apportioned. When the narrow transactional test is applied to expense determination, it disallows expenses that are deductible in calculating total unitary income subject to tax. By doing so, Kansas has gone beyond what is constitutionally permitted. Had Kansas analyzed Kroger's expense under the unitary business

concept, the expense would have been allowed as a deduction apportioned against unitary income, regardless of the expense's characterization under Kansas' statutes. The interest expense at issue is the flip side of interest income from working capital, something clearly subject to apportionment under the unitary business principle. *Allied-Signal,* 504 U.S. at 787. Interest on borrowed capital should be treated the same as interest earned on invested capital. In failing to apply the unitary business concept to this interest expense, Kansas disallowed the entire interest deduction, thereby subjecting Kroger to tax on extraterritorial value in the same manner that California's unconstitutional interest disallowance was held to impermissibly result in taxation of nonunitary income in *Hunt-Wesson.*

Both the Commerce and the Due Process Clauses limit a state's ability to tax value earned outside its borders. U.S. Const. art. I, § 8, cl. 3; U.S. Const. amend. XIV, § 1. States cannot end-run the constitutional limitations by disguising a tax on extraterritorial income as an expense disallowance. The question before the Court in *Hunt-Wesson* was "[d]oes the Constitution permit California to carve out an exception to its interest expense deduction, which it measures by the amount of nonunitary dividend and interest income that the nondomiciliary corporation has received?" *Hunt-Wesson,* 528 U.S. at 463. The question before this Court is similar; does the Constitution permit Kansas to carve out an exception to its interest expense deduction, which it measures by the transactional test? Because the transactional test does not parallel the unitary business concept, and, in fact is much narrower, it results in the disallowance of interest beyond that permitted by the Constitution.

As in the present case, the California statute at issue in *Hunt-Wesson* did not directly impose a tax on nonunitary income. Rather, it denied the taxpayer use of a portion of its interest deduction from unitary income. *Hunt-Wesson,* 528

U.S. at 464. However, as the Court in *Hunt-Wesson* recognized, a " 'tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes.' " *Id.* at 464 (citing *Trinova Corp. v. Michigan Dept. of Treasury*, 498 U.S. 358, 374 (1991), quoting Jenkins, *State Taxation of Interstate Commerce*, 27 Tenn. L. Rev. 239, 242 (1960)). Similarly, a deduction limitation on unitary expenses measured by the state's definition of "nonbusiness expenses" is a tax on nonunitary income to the extent the state applies a test narrower than the unitary business principle to expense determination.

Although California's interest offset (deduction reducing) provision operated to increase the amount of income subject to taxation (by reducing the deduction by precisely the amount of nonunitary income that the taxpayer received), the present method of reducing interest accomplishes the same end by slightly different means. Unlike *Hunt-Wesson*, Kansas ignores whether Kroger has nonunitary income in determining whether to disallow the interest expense. Instead, Kansas completely disallowed Kroger's interest deduction by applying a test known to be narrower than the unitary business concept.

The Court, in *Hunt-Wesson*, recognized that deduction denials that "represent reasonable efforts properly to allocate a deduction between taxable and tax-exempt income" are constitutional. *Hunt-Wesson*, 528 U.S. at 466. Because California's interest offset provision did not reasonably allocate deductions to the income that the expense generated, this Court held that the provision "constitutes impermissible taxation of income outside its jurisdictional reach." *Id.* at 468. Kansas' absolute denial of interest expense based on the transactional test's restrictive view does not represent a reasonable attempt to pair unitary income and unitary expenses. To the extent the State's definitions of business income and business expense mirror the constitutional

limitations, no problem exists; to the extent the State's definitions are narrower than the constitutional limitations, the State unreasonably pairs unitary expense with nonunitary income.

States that use the "business income" standard to determine whether expenses should be apportioned violate the unitary business principle as long as the state has defined the business income test to be something narrower that the unitary business principle. This approach fails to meet constitutional requirements and is compounded in states that use only the transactional test. While states may narrowly capture income from activities meeting the transactional or functional test (whichever the state imposes) in their apportioned tax base, using the same rules to apportion or allocate expenses will violate the unitary business principle.

The Court has the opportunity in this case to further its analysis identifying expense disallowance that results in unconstitutional taxation of extraterritorial values and, more importantly, to offer state taxing jurisdictions a template to prevent future violations. While this Court has recently affirmed that a state may not tax extraterritorial values through unreasonable expense disallowance, states have failed to recognize that *Hunt-Wesson* applies outside California.[10] As a result, states rely on a variety of incomplete shortcuts—such as the application of UDITPA or the transactional or functional tests—to determine which expenses must be allocated or apportioned. These shortcuts, while in some cases sufficient to meet constitutional strictures, fail in other situations (as evidenced here) to protect the taxpayer's constitutional rights. Thus, a decision by the Court in the present case is necessary to explain the

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[10] We would respectfully suggest the Court to note California's attempt to reduce *Hunt-Wesson* to a historical anomaly by means of administrative promulgation. *See* Cal. Franchise Tax Bd. Notice 2000-9 (Dec. 19, 2000).

constitutional limitations against taxing extraterritorial values and establish the test for determining when such limits are violated by expense disallowance.

CONCLUSION

For the reasons stated above, and because this approach to expense disallowance is spreading to other states, COST respectfully requests the Court to accept this case for review.

Respectfully submitted,

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